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DEPARTMENT OF AUDITOR-CONTROLLER

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To: Supervisor Don Knabe, Chairman
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From: J. Tyler McCauley
Auditor-Controller

Pastor Herrera, Jr., Director
Department of Consumer Affairs

Subject: **CABLE TELEVISION FRANCHISE FEE AUDITS (Board Agenda Item 9, August 3, 2004)**

On August 3, 2004, your Board directed the Auditor-Controller (A-C), in conjunction with the Director of the Department of Consumer Affairs (DCA), to evaluate establishing regular audits of cable television franchise fee collections and the use of the Cable Television Franchise Fund (CTFF), to pay for the cost of the audits. In addition, the Board requested that we propose ways the contracts can be strengthened to ensure cable television companies comply with contract requirements.

Background

The County of Los Angeles contracts with seven cable television companies serving 36 designated unincorporated areas. Cable companies pay franchise fees to the County in exchange for their use of the County public rights-of-way. The franchise fees represent five percent of their gross revenues. These fees are billed to their cable subscribers and appear as a line item on all cable bills.

Cable companies report their gross revenues and remit payment of franchise fees to the County A-C. In addition, DCA monitors cable companies to ensure payment was made by requiring them to provide evidence of payment. Franchise fees are allocated fifty percent to the general fund and fifty percent to the CTFF. For calendar year 2003, the seven cable companies reported gross revenues of $80,030,533 and paid the County a total of $4,004,027.

Audits and Audit Cycles

Audits of cable television franchises are not mandatory. However, periodic financial audits are initiated by DCA as part of its regulatory responsibilities. The purpose of these audits is to ensure that cable companies are reporting revenues accurately, and that the County is receiving all of the franchise fees it is owed.

Over the past four years, 23 of the 36 (64%) franchise areas have been audited, covering an average period of five years for each franchise area. Audits have identified discrepancies in franchise fees remitted and due to the County. In addition, audits have raised issues which have created a need to strengthen franchises/contracts and County Code, which are discussed in the next section. DCA resolves discrepancies in franchise fees remitted by invoicing cable companies when underpayments are identified or by issuing credits when overpayments exist. The issues raised by audits are more complex. As a result, DCA addresses them in consultation with various sources such as the A-C, County Counsel and private counsel.

DCA selects franchises for audit at their discretion and does not have an established audit cycle. However, DCA does develop an audit plan on an annual basis. Some of the factors DCA takes into consideration during their audit selection process are the last time the franchise was audited, problems identified in previous audits, and current problems identified in the course of compliance reviews. However, other factors can also influence the selection. For example, the most recent selection consisted of Adelphia franchises because of Adelphia's bankruptcy filing and the filing of criminal charges against its principals. DCA determined that there was a need to identify whether Adelphia's accounting practices were compromised.

While DCA's annual audit plan and current audit selection process are reasonable, we believe developing an audit cycle to audit franchises regularly will ensure more consistent monitoring of cable companies. In addition, it will allow DCA to determine more frequently if cable companies are reporting revenues accurately, and that the County is receiving all of the franchise fees it is owed. The A-C believes that DCA should develop an audit cycle to ensure franchise areas are regularly audited.

Recommendation

1. **DCA develop an audit cycle to ensure franchise areas are regularly audited.**

Strengthening of Franchises/Contracts and County Code

Issues identified during the course of franchise fee audits have resulted in a need to strengthen contracts. For example, there were instances where cable companies could not provide documentation to support the gross revenue amounts they reported because the documents could not be found. In addition, more recent audits revealed that cable companies were not paying franchise fees on revenues from programmers (launch fees) because they do not consider launch fees as revenue.

We noted 28 of the 36 existing franchises (78%) will be up for renewal in 2005, making it an ideal time to amend existing requirements. However, most contract requirements relating to financial audits are addressed in the County Code. For example, County Code 16.60.157 allows DCA to assess liquidated damages of $50 a day for specific failures to comply with this code. Increasing liquidated damages should offer cable companies a greater incentive to comply. As a result, language to strengthen contract provisions needs to be effected through changes to the County Code. DCA has been working along with County Counsel, A-C, Department of Public Works and CAO on revising County Code to strengthen and standardize terms with emphasis on greater penalties for non-compliance.

Recommendation

2. **DCA continue to work with County Counsel, Auditor-Controller, Department of Public Works and Chief Administrative Office on revising County Code to strengthen and standardize terms with emphasis on greater penalties for non-compliance.**

Audit Costs - Funding

DCA has franchise fee audits performed if they are able to identify savings in their allocated budget, primarily from Salary & Employee Benefits. DCA does not include audits as part of their established budget. Audits have been contracted out to various audit firms with A-C management serving as the contract liaison. The schedule below shows the costs of the audits and the number of areas audited over the last four work orders.

FY	Work Order (W/O) #	W/O Maximum Cost	# of Franchise Areas Audited	Average # of Calendar Years Reviewed Per Franchise
2000-01	5-50	$ 64,528.00	10	6.2
2001-02	5-65	$ 60,000.00	7	5.0
2002-03	6-58	$ 106,254.42	8	4.6
2003-04	6-82	$ 61,427.00	6	3.0
Averages		$ 73,052.36	8	4.7

The average cost of a work order has been approximately $73,000 and has covered on average eight franchise areas with approximately five years being reviewed per area. However, DCA also incurs additional expenses as a result of these audits. For example, the A-C bills DCA for monitoring and administering the work order and DCA staff work with issues that arise during the course of the audits.

In 1981, the Board adopted Ordinance No. 12,319 which indicates that 40% of the franchise fees will be placed in an interest bearing account for use in future funding of a cable regulatory program pending approval by the Federal Communications Commission (F.C.C.) of the five percent franchise fee. The Cable Communications Policy Act of 1984 provided for a five percent franchise fee ceiling, the use of which is unrestricted and no longer subject to F.C.C. approval. Also in 1984, the Board established a Cable Communications Taskforce to recommend a plan for the use of the five percent franchise fees.

The Cable Communications Taskforce recommended to continue holding the already collected franchise fees in the existing special fund pending direction from the Board and to deposit 40% of the fees collected into the CTFF to be used for cable-related purposes. In 1999, the Board approved an increase in the allocation of franchise fees into the CTFF from 40% to 50%.

Over the past three fiscal years, the CTFF has received $1.9 million for each of FY 2001-02 and 2002-03, and $1.8 million for FY 2003-04 in franchise fee revenue. In addition, the CTFF had ending fund balances of approximately $3.4, $3.9 and $3.5 million for FY 2001-02, 2002-03 and 2003-04, respectively.

We believe the CTFF can be used as a funding source to cover the cost of franchise fee audits and has sufficient funds to allow an increase in DCA's allocation. Therefore, DCA should request additional budget funds from the CTFF to pay for franchise fee audit costs.

Recommendation

3. **DCA request additional budget funds from the Cable Television Franchise Fund to pay for franchise fee audit costs.**

Conclusion

DCA should develop an audit cycle to ensure franchise areas are regularly audited. In addition, DCA should continue to work with County Counsel, Auditor-Controller, Department of Public Works and Chief Administrative Office on revising County Code to strengthen and standardize terms with emphasis on greater penalties for non-compliance. DCA should also request additional budget funds from the Cable Television Franchise Fund to pay for franchise fee audit costs.

If you have any questions or need additional information, your staff may contact Ian Clark at (626) 293-1104.

JTM:MMO:IDC:mr

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